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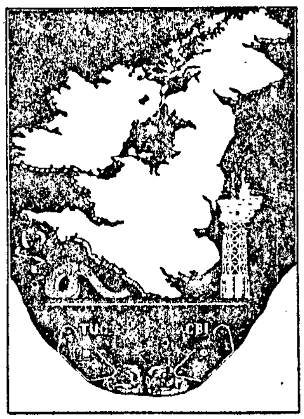


THE BRITISH ECONOMY

By Walter Eltis

THERE IS considerable pessimism about 1983, but it could in fact be the year in which the economy begins to come right. It should be the first of Mrs Thatcher's years in office in which the real money supply rises significantly and the first in which the ratio of taxation to the national product falls. These should both produce economic benefits.

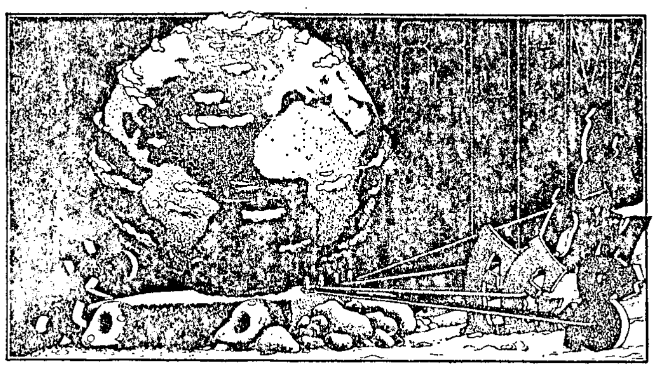
Monetary economists believe that financial markets tend to be depressed if the money supply grows more slowly than he price level. This causes those who become short of cash to seek to convert liquid assets into money which raises interest rates, pulls down house and share prices and produces weak markets for capital and consumer goods. Where the money supply rises substantially faster than prices, cash exceeds current needs, with the result that buying orders for shares of all kinds predominate over selling orders, while equally favourable conditions are created in the markets for real estate and durable consumer goods. Growth in the real money supply may of course lead to extra purchases of foreign shares and so depress the exchange rate, while tight money may sharply raise this.

The table shows how drastically, the real money supply fell in Mrs Thatcher's first year. M1 — money supply according to its narrower definition — increased by 14 per cent less than prices in 1979-1980, sterling M3 by 5 per cent less and PSL2 (private sector liquidity) by 8 per cent less. All three measures of the money supply therefore indicate the tightening of financial markets and these were indeed extremly depressed, while interest rates rose sharply as portfolio holders and finance houses attempted to maintain adequate liquidity, and the exchange rate shot upwards. The influence of the real money supply on financial markets was approximately neutral in Mrs Thatcher's second and third years.

If attention is focused on M1 there was a slight further tightening, while money became looser according to the sterling M3 measure. But it is well known that this was severely distorted by the removal of the corset, and by the faster growth of bank housing loans (which influence Sterling M3) than of building society loans which do not. The PSL2 measure does not suffer from these distortions, and this indicates an approximately stable real money supply from the summer of 1980 to the summer of 1982.

The real money supply started to grow very sharply indeed last summer. Retail prices rose by only 1.3 per cent in the six months May to November 1982, but in these same months M1 rose 8.4 per cent, Sterling M3 by 6.3 per cent and PSL2 by 4.2 per cent. Financial markets were thereby given an upward twist and these favourable effects should continue. The Government is likely to raise the money supply by something like 10 per cent in the next 12 months, while it is almost universally agreed that retail prices will rise by only 5 per cent or 6 per cent and possibly by less. Few fear a wage round of more than 6 per cent or 7 per cent and with productivity rising at 2 per cent or 3 per

The need for new initiatives to oil the growth mechanism



THE WORLD ECONOMY

By Jan Tumlir

TWO LARGE question-marks obstruct the view as we peer into 1983. Can an international financial crisis be avoided? Will inflation reaccelerate? Clearly, the two questions are not unrelated.

In industrial countries, economists see technical factors falling into place that, in normal conditions, would make for an upswing. Inventories are low, the financial balance of households has improved as consumer debt has been drawn down and residential construction is showing signs of an upturn.

Additional positive factors may be arising from the very duration of the recession. In households as well as companies, increasingly the replacement of and improvement in the stock of durable equipment can no longer be postponed. New lines of activity, profitable even in generally depressed con-

and falling commodity prices since 1980. These changes merely terminated a clearly unsustainable development, namely, the pronounced acceleration of international lending after 1973, concurrent with a progressive narrowing of trade opportunities. The unusually high proportion of international capital flows absorbed by the non-oil developing and centrally planned economies, and the growing use of subsidies and trade restrictions by the industrial countries, reflected the unwillingness or inability of the latter to allow a structural adjustment of their economies.

Even if economic activity quickened next year, the financial problem, though somewhat easier to handle, would be far from solved. Analysis suggests also, however, that a resumption of sustainable growth rates is unlikely as long as the industs 1983

etter news on the way

cent, wage costs per unit should rise only 4 per cent or 5 per cent.

The forecasts of a fall in the oil price at some point in the year underline how commodity prices are more likely to fall than to rise, and with cuts in taxation in prospect, business costs should rise by only 3 per cent or 4 per cent. A 5 per cent rise in prices should therefore actually permit some widening in profit margins. Prices could even rise by as little as 5 per cent or 6 per cent if there is a modest fall in the exchange rate as a result of a lower price of oil. With 10 per cent nominal monetary growth in 1983, the real money supply is bound to grow if inflation is held down in this way, and that should prove an expansionary force — the converse of the deflationary influence of the shortage of money in 1979-80.

A second favourable influence on prospective demand and output should follow from the Government's success in controlling public expenditure. Many of its policies to achieve this have been slow to take effect, but they are now coming through very strongly indeed. The nationalised industries and the local authorities are at last spending less, public sector pay is rising more slowly than private sector pay, lower interest rates are reducing the cost of financing the national debt, and it is generally recognised that these influences might well combine to produce an undershoot of Government borrowing of £2bn in fiscal 1982-83.

That would permit tax cuts of £3bn if Sir Geoffrey Howe expects economic growth in 1983 to produce some buoyancy in tax revenues. He should therefore be able to cut taxes by something like 1 per cent off the national product and at the same time reduce borrowing in line with the Medium-Term Financial Strategy.

If Sir Geoffrey is cautious about the growth in tax revenues and gives priority to reducing borrowing further, he might not feel free to cut taxes by as much as this. There are inevitably great uncertainties in the estimation of future Government revenues and expenditures and the key decision for the Chancellor will be whether to hedge against the possibility ... prove

ing requirement, with the result that he under-estimated the scope for tax cuts by some £2bn. He has apparently repeated this error in 1982-83 as borrowing is again likely to be well below the amounts expected in March.

This budgetary caution has allowed shock expenditures like the Falklands war to be financed with ease, but it would be strange if, with unemployment approaching 3½m (according to the former series) he continues to budget so cautiously. His colleagues will surely seek to persuade him to risk cutting taxes a little too much on this occasion rather than accept the possibility that taxes might actually be cut a good deal less than the Medium Term Financial Strategy requires.

The recent failure of Opec to agree on production quotas means that the oil price and therefore the Government's oil revenues are now quite vulnerable. If the oil price falls before the Budget, some of the potential for tax cuts will of necessity take the form of a lower oil price and therefore lower oil taxation. But this will stimulate the economy in the same way as alternative tax cuts which fall partly on the consumer and partly on industry's costs.

It may be hoped that a combination of an increase in the real money supply of 4 or 5 per cent, which will please monetarists, and tax cuts of 1 per cent of the national product, which will please Keynesians, will set off the economic revival that has been awaited so impatiently.

There may, moreover, be good news during 1983 from the expansion of small businesses. The Government has been encouraging the growth of new businesses through lower marginal personal taxation, enterprise zones etc for 3½

At some point this will begin to have a measured impact on output and employment and when this starts to come through the conventional forecasts which ignore supply-side effects that develop over long periods will be caught off-balance. These favourable effects could begin during 1983, but their timing is in no way predictable. The good news could emerge at any time.

What might go wrong with the relatively optimistic view of 1983 which would follow if the favourable factors that have been outlined were the only ones that mattered?

The first worry is the weakness of the world economy. The U.S. recovery is expected in the summer of 1983 at the earliest, and with Japanese and German output slack, the French forced to curtail their Keynesian experiment, and the Italians desperate to control their deficit, recovery will depend almost entirely on the U.S. British employment now depends far more than it used to on the world economy. EEC entry has boosted Britain's exports of producer goods, but it has raised imports of consumer goods still more. This means that if the overseas markets for our electrical machinery and chemicals are weak, employment will not be especially assisted by boosts to domestic consumption which go increasingly to imports.

A growing real money supply and tax cuts may therefore help British producers less than they assist foreign sales in Britain. This reservation does not apply to building and construction which is entirely domestic. If the demand for British manufactures is now dominated by foreign markets, a boost to construction may have become the principal way in which British governments can raise employment in the short term.

UK REAL MONEY SUPPLY

(Percentage changes)

	M1	£M3	PSL2
1979 II to 1980 II	−14.0	− 5.0	− 8.4
1980 II to 1981 II	− 1.3	+ 4.4	+ 1.8
1981 II to 1982 II	− 2.1	+ 2.3	− 0.2
1982 May to November	+ 7.0	+ 4.9	+ 2.9

The increase in the series for M1, £M3 and PSL2 (private sector liquidity) deflated by the rise in retail prices.

the real money supply will much reduce British interest rates in a pre-election year.

Will it really be possible for Mrs Thatcher to borrow long at 8 per cent, which is what interest rates should fall to with inflation at 5 per cent, if there is some possibility that this interest will actually have to be paid with money printed by Mr Foot?

With his proposed £30bn boost to public expenditure, accompanied by the prospect of a large devaluation, or else a collapse of sterling and no incomes policy (of the kind which made it possible to reduce inflation from 30 to 10 per cent in 1975-79) Britain's expected inflation rate would soar in any period in which a Labour victory appeared possible. Portfolio holders would then switch out of British bonds so that interest rates would rise, whatever the behaviour of the real money supply. Growth in this would then reduce the value of sterling instead of raising British stock exchange prices, and very possibly persuade the Government to raise short-term interest rates to protect the exchange rate yet again.

It must be kept in mind that the exchange rate of sterling does not depend solely on developments in Britain. A flight from sterling, as a result of political risks which would tend to depress the pound (or else raise the short-term interest rates needed to sustain it) is one possibility, but happily there are others. The ideal conditions for Britain in 1983 would be a fall in the dollar which would cheapen our raw materials and a rise in the D-Mark which would make our exports more competitive. These developments are by no means unlikely.

The U.S. current account is chronically weak while monetary growth is accelerating, so the dollar could fall sharply at any time. In Germany the new CDU-dominated coalition is tightening the budget which could easily produce the familiar exchange rate appreciation that conservative financial policies always produce at first. British industrialists desperately wish to increase our competitiveness in relation to the EEC economies, while they see little need for a further fall in the pound in relation to the dollar. That may be precisely what